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New Zealand Milk Production and Dairy Manufacturing Report May 2013

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Report Highlights:

End of the golden weather: drought reduces pasture production in 2013 causing milk production to be reduced by 7% to 19.2 million metric tons. Dairy product exports only likely to be effected by 2%. WMP will continue to be produced in increasing volumes.

Executive Summary

The golden run New Zealand dairy farmers enjoyed over the eighteen months from mid 2011 to the end of 2012 came to an end early in 2013. Now the milk supply for 2013 is forecast at 19.2 million metric tons (MT) close to 7% below the boom year of 2012 which saw production soar to 20.6 million MT. Over the period from the end of 2010 to the end of 2012, thanks to increased cow numbers and consistently high pasture production, the milk supply leapt up 19%. However drought conditions over the whole of the North Island and parts of the South Island from January 2013 through to April 2013 have dealt a severe blow to milk production in the first half of the year. The aftereffects of the drought, lower conditioned cows and less pasture supplies will hamper production in the second half of the year as well.

The lower milk supply in 2013 will result in lower dairy product production overall. However Whole Milk Powder production (WMP), the most efficient commodity for NZ to produce, will continue to increase. New production capacity coming on-line during 2013 should mean production will reach close to 1.3 million MT just ahead of 2012. Skim Milk Powder may well be the only other main commodity to remain at a similar production level in 2013, at 400,000 MT. Fat production is likely to be down from 527,000 MT in 2012 to 494,000 MT in 2013. Cheese production which is the most expensive of the main commodities to produce is likely to drop some 15% to a revised forecast of 270,000 MT in 2013.

Exports are not likely to be reduced as much as the drop in milk supply would suggest because the buildup of inventory during 2012 will be reduced in 2013. It is now forecast total export volume will be 2.75 million MT in 2013, a 2% drop from 2012. Only WMP and SMP exports are forecast to be above 2012 levels, at 1.3 million MT and 405,000 MT respectively.

On the policy front there has been a steady diet of new activity or announcements over the last six months. The most notable have been:

Further amendments to the Raw Milk Regulations which make up part of the Dairy Industry Restructuring Act passed into law in November 2012. At the end of November Fonterra's major capital restructuring vehicle, TAF or Trading Among Farmers, came to life and trading began for both Fonterra shares on a private exchange and the Fonterra Shareholder Fund's units on the New Zealand Stock Exchange. Then the New Zealand Commerce Commission released its first report of the statutory review of Fonterra's Milk Price Manual which provides the methodology as to how Fonterra calculates the milk price it pays its farmer shareholders each year.

At the end of January 2013 a media frenzy ensued when the Ministry for Primary Industries announced traces of Dicyandiamide (DCD) had been found in milk powder being exported. It was not a food safety issue but there seemed to be some hesitancy over how to handle the issue and the negative publicity that would arise.

Production

Dairy, Milk, Fluid	2011		2012		2013	
	Market Year Begin: Jan 2011		Market Year Begin: Jan 2012		Market Year Begin: Jan 2013	
New Zealand	Official	New Post	Official	New Post	Official	New Post
Cows In Milk	4816	4816	5021	5021	5075	5018
Cows Milk Production	18965	18965	20348	20567	20400	19169
Other Milk Production	0	0	0	0	0	0
Total Production	18965	18965	20348	20567	20400	19169
Other Imports	2	2	1	1	1	1
Total Imports	2	2	1	1	1	1
Total Supply	18967	18967	20349	20568	20401	19170
Other Exports	123	123	100	96	120	110
Total Exports	123	123	100	96	120	110
Fluid Use Dom. Consum.	300	300	300	275	300	270
Factory Use Consum.	18494	18494	19899	20147	19931	18740
Feed Use Dom. Consum.	50	50	50	50	50	50
Total Dom. Consumption	18844	18844	20249	20472	20281	19060
Total Distribution	18967	18967	20349	20568	20401	19170
CY Imp. from U.S.	0	0	0	0	0	0
CY. Exp. to U.S.	0	0	0	0	0	0
TS=TD		0		0		0
(1000 Hd, 1000MT)						

Note: Data included in this report is not official USDA data. Official data can be found at <http://www.fas.usda.gov/psd>

Milk Supply 2013

Milk Supply in 2013 is expected to undergo a more severe contraction than had been previously forecast, and is now projected to decline to 19.17 million metric tons (MT). This is a reduction of 5% from original forecasts and represents a significant decrease in supply of close to 7% when compared to last year's level.

Widespread drought conditions overall the dairying areas in the North Island, as well as parts of the South Island, all but halted pasture growth from late January to mid March, and is the major factor behind the overall milk supply reduction. Milk production during the January to June period is expected to be 14% to 15% below the corresponding period in 2012. Reports in some districts indicate daily milk collection levels that are reaching only 30% of last year's daily collection levels for the month of April.

Once it became apparent that cows on many farms would have to be fed entirely on unprofitable supplementary feeds, farmers reduced the frequency of milking or dried cows off completely to reduce the feed demand. Industry participants have estimated 10% to 12% of farms had completely stopped milking by early April compared with the same period in 2012.

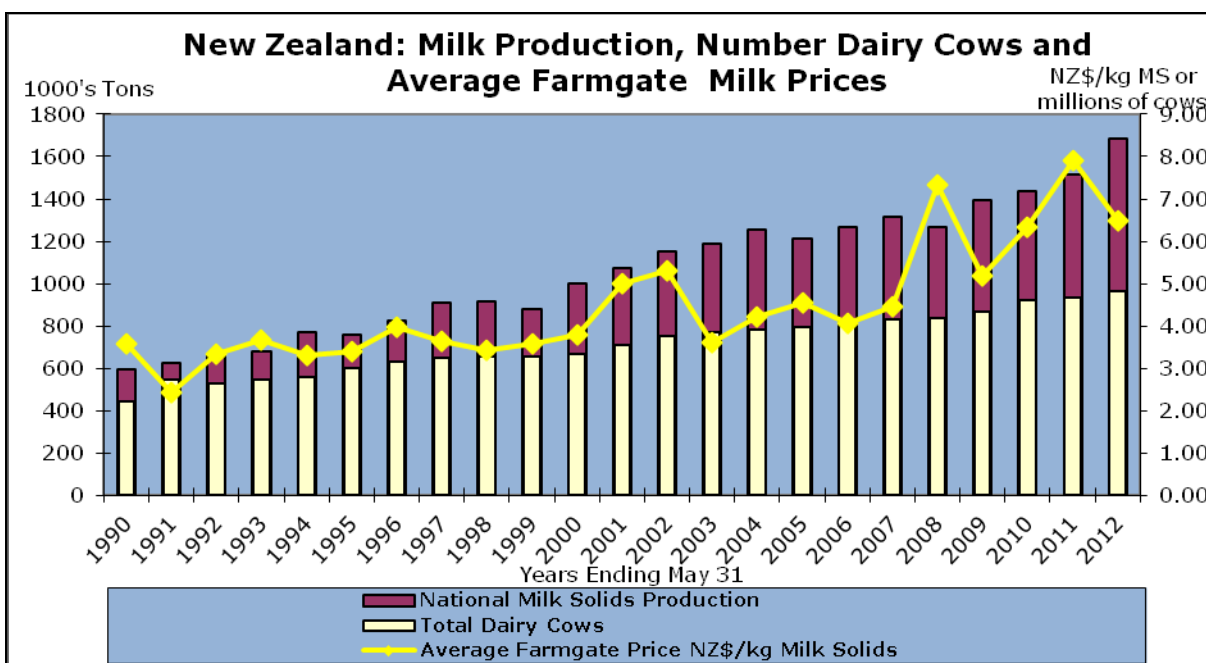
In addition, farmers culled their herds early and severely. The national cow kill for the first quarter (Q1) 2013 is estimated at 179,000 head, more than double the level during the same period in 2012. However, the rate of slaughter has slowed in April. Despite these underlying factors, Post still estimates that overall cow numbers will remain stable relative to 2012 at just over 5 million head. While in general cow numbers in the North Island will be lower, this will be compensated for

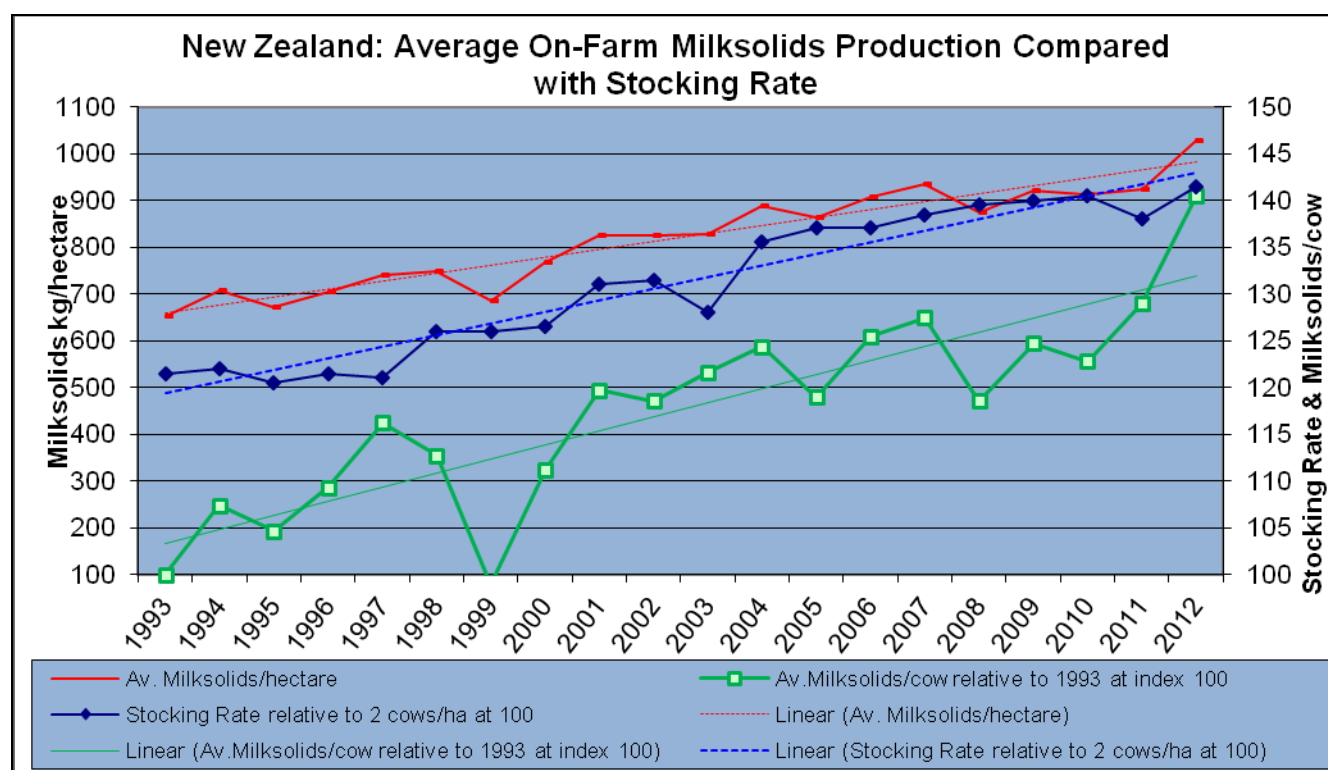
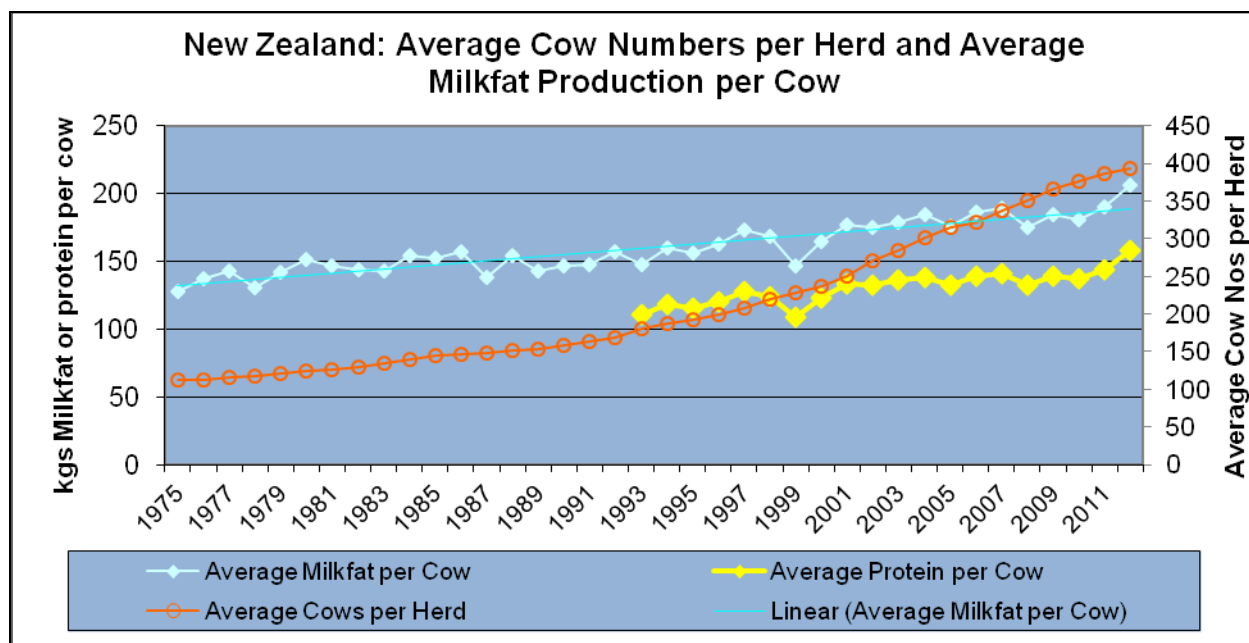
in the South Island where numbers are expected to increase due to approximately 45 farm conversions to dairy, and where producers continue to build up cow numbers up.

The ongoing effects of the drought are still likely to be felt in the second half of the year, unless spring weather conditions are far better than normal allowing both high pasture growth and better utilization by the cows. Based on current industry anecdotal information, dairy herd condition is generally below 2012 levels. In addition, with less supplemental feed on hand Post is forecasting that the total New Zealand milk supply in 2013 from July through December will be approximately 3% lower when compared with the same period in 2012.

Milk Supply 2012

The end of 2012 capped off nearly two years of superb production conditions which finally meant even Posts optimistic projections in October 2012 were surpassed by 1 %, with actual milk production reaching 20.6 million MT. Milk supply increased by nearly 19% from 2010 to the end 2012. This compares with average trend increases which are normally on the order of 2% to 5% per annum. This “perfect storm” was driven by a combination of increased herd size combined with phenomenal pasture growth which allowed all cows to express their true merit.





Production of Dairy Products

In 2013 a milk supply of 19.17 million MT will mean after domestic consumption and liquid milk exports 18.8 million MT will be available for processing.

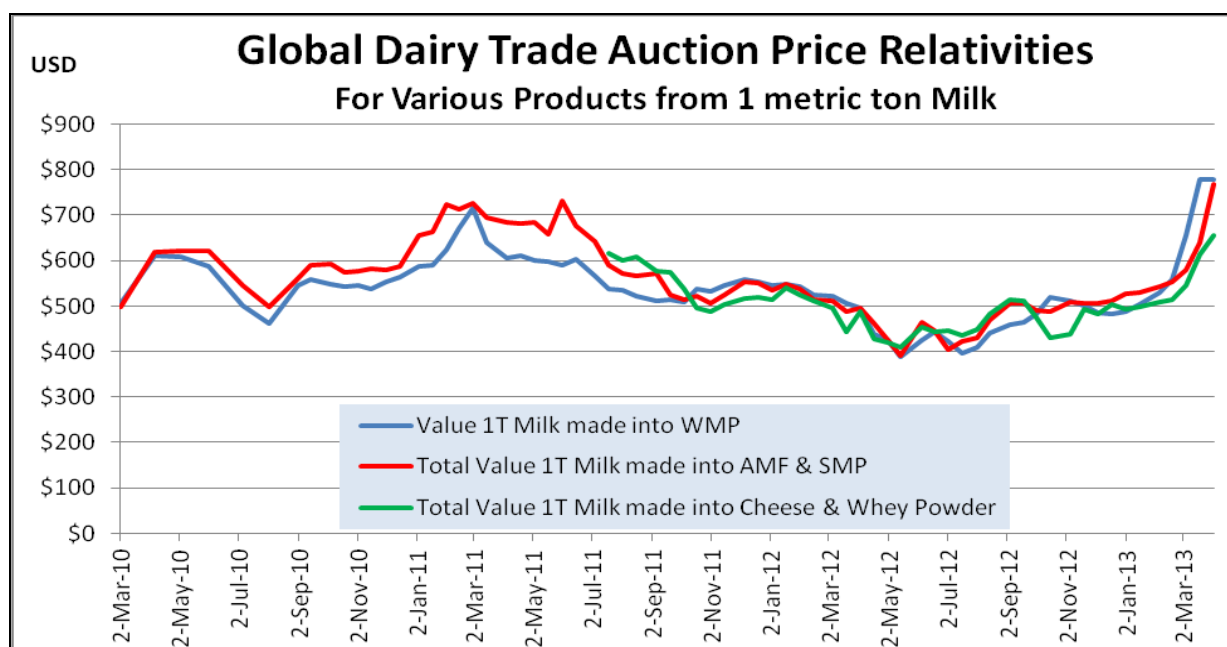
Whole Milk Powder (WMP)

Dairy, Dry Whole Milk Powder New Zealand	2011		2012		2013	
	Market Year Begin: Jun 2011		Market Year Begin: Jun 2012		Market Year Begin: Jun 2013	
	Official	New Post	Official	New Post	Official	New Post
Beginning Stocks	99	99	129	150	153	161
Production	1,141	1,162	1,250	1,273	1,270	1,275
Other Imports	1	1	1	1	1	1
Total Imports	1	1	1	1	1	1
Total Supply	1,241	1,262	1,380	1,424	1,424	1,437
Other Exports	1,110	1,110	1,225	1,261	1,295	1,285
Total Exports	1,110	1,110	1,225	1,261	1,295	1,285
Human Dom. Cons.	2	2	2	2	2	2
Other Use, Losses	0	0	0	0	0	
Total Dom. Cons.	2	2	2	2	2	2
Total Use	1,112	1,112	1,227	1,263	1,297	1,287
Ending Stocks	129	150	153	161	127	150
Total Distribution	1,241	1,262	1,380	1,424	1,424	1,437
CY Imp. from U.S.	0	0	0	0	0	0
CY. Exp. to U.S.	1	2	0	3	0	3
TS=TD		0		0		0
(1000 MT)						

For 2013 Whole Milk Powder (WMP) production has been revised upward by 2 % compared with the previous forecast, to 1.275m MT. Production in 2012 has also been revised to 1.273m MT. This is up 2% from the previous estimate, and is the result of higher milk supply and new processing assets coming on stream in 2012. With additional processing capacity becoming available in 2013 it is likely that WMP production in 2013 will surpass 2012 production levels.

WMP is still basically the product of choice and New Zealand has a competitive edge -- both in the higher protein content of domestically produced milk and in processing efficiencies. The high protein content in the milk makes it easier to meet product specifications. In addition, New Zealand imports lower value lactose which is used to standardize protein levels down to meet product specifications. However the 2013 revised production forecast indicates a slower rate of growth in 2013 than the recent historical trend would suggest. This is due to the forecast reduced milk supply for 2013.

Virtually all the increased primary processing capacities which have come on stream over the last year and will come on stream during 2013 are powder driers primarily for producing WMP. For example Fonterra will commission perhaps the highest capacity drier presently in the world when the 30 MT per hour facility at Darfield in the South Island opens in August 2013.



Source: GTA, GDT, Post estimates

The chart above shows the main 4 commodities move relatively in sync when the underlying values of the protein and fat in each product are shown based on how much of each product one metric ton of milk would produce. For New Zealand, because WMP is the most cost effective product to produce it is the first choice product.

Butter and Anhydrous Milkfat (AMF) Production

Dairy, Butter New Zealand	2011 Market Year Begin: Jan 2011		2012 Market Year Begin: Jan 2012		2013 Market Year Begin: Jan 2013	
(1000 MT)	USDA Official	New Post	USDA Official	New Post	USDA Official	New Post
Beginning Stocks	29	29	33	48	32	48
Production	472	487	499	527	490	494
Other Imports	1	1	1	0	1	1
Total Imports	1	1	1	0	1	1
Total Supply	502	517	533	575	523	543
Other Exports	449	449	480	506	474	474
Total Exports	449	449	480	506	474	474
Domestic Cons.	20	20	21	21	21	21
Total Use	469	469	501	527	495	495
Ending Stocks	33	48	32	48	28	48
Total Distribution	502	517	533	575	523	543
CY Imp. from U.S.	0	0	0	0	0	0
CY. Exp. to U.S.	22	22	28	32	28	28
TS=TD		0		0		0

Note: AMF production is multiplied by 1.22 to get a butter equivalent tonnage.

Post is forecasting fat production of 494,000 metric tons of butter equivalent for 2013, a slight 1% increase from the previous forecast. For 2012, however, production has been revised upward significantly to 527,000 MT butter equivalent. This represents a 6% increase compared to the

previous estimate, and an 8% year-over-year increase. This estimate is based on the actual export tonnage and the knowledge that at peak, daily milk inflows in 2012 implied that all processing facilities were at capacity and that processors had no alternative but to produce Skim Milk Powder (SMP) and AMF.

On a year on year basis total fat production in 2013 is now forecast to be 6% less than 2012 owing to the forecast reduction in milk supply.

New Zealand dairy product suppliers are working to supply cream and fat products to baked goods manufacturers in the key markets of Australia and Asia as they see considerable potential for growth in this category.

Skim Milk Powder (SMP)

Dairy, Milk, Nonfat Dry New Zealand (1000 MT)	2011 Market Year Begin: Jan 2011		2012 Market Year Begin: Jan 2012		2013 Market Year Begin: Jan 2013	
	USDA Official	New Post	USDA Official	New Post	USDA Official	New Post
Beginning Stocks	51	51	54	54	62	70
Production	366	366	386	404	380	400
Other Imports	2	2	5	5	4	4
Total Imports	2	2	5	5	4	4
Total Supply	419	419	445	463	446	474
Other Exports	362	362	380	390	390	405
Total Exports	362	362	380	390	390	405
Human Dom. Cons.	3	3	3	3	4	4
Other Use, Losses	0	0	0	0	0	0
Total Dom. Cons.	3	3	3	3	4	4
Total Use	365	365	383	393	394	409
Ending Stocks	54	54	62	70	52	65
Total Distribution	419	419	445	463	446	474
CY Imp. from U.S.	0		0	0	0	0
CY. Exp. to U.S.	0	1	0	0	0	0
TS=TD		0		0		0

SMP production in 2013 is forecast at 400,000 MT. This represents a 5% upward revision from previous estimates for 2013, yet is slightly below Post revisions of 2012SMP production, now pegged at 404,000 MT.

Similar to butter and AMF, SMP is just behind WMP in terms of cost effectiveness to produce. But in a year where milk supply will be limiting, SMP production will be preferred relative to Cheese, Casein and Milk Protein Concentrates (MPC). Thus it is likely NZ dairy processors will firstly aim to satisfy demand for WMP, SMP and AMF/Butter, but will reduce Cheese, Casein and MPC production in line with the reduction in milk supply.

SMP is a basic ingredient that is used in various value-added consumer products such as yogurt and ice-cream, and is often used in the manufacture of nutritional formulas such as infant formula. Industry experts believe that these market segments are where the NZ dairy industry can maintain and enhance profitability into the future.

This year Synlait, an independent milk processor 51% owned by Bright, a Chinese company, will ramp up its production of infant formula, having finished installing a nutritional drier in 2012. Fonterra has announced it is going to progress from being an ingredient supplier to formula marketers like Nestle to getting heavily involved in producing its own nutritional formulas under its own brands for Chinese markets. It will add the processing infra-structure as needed. In addition two Chinese dairy companies (Villi and Yashilli) now have Overseas Investment Office consent to build processing facilities in NZ which will be primarily aimed at producing infant formula. The two other NZ Co-ops Westland and Tatua are also evaluating or at the final decision stage on investing in this area of value add production as well.

Cheese Production

Dairy, Cheese New Zealand	2011		2012		2013	
	Market Year Begin: Jan 2011		Market Year Begin: Jan 2012		Market Year Begin: Jan 2013	
(1000 MT)	USDA Official	New Post	USDA Official	New Post	USDA Official	New Post
Beginning Stocks	40	40	32	62	42	50
Production	270	300	310	319	300	270
Other Imports	5	5	5	5	5	5
Total Imports	5	5	5	5	5	5
Total Supply	315	345	347	386	347	325
Other Exports	253	253	275	306	285	260
Total Exports	253	253	275	306	285	260
Human Dom. Cons.	30	30	30	30	30	30
Other Use, Losses	0	0	0	0	0	0
Total Dom. Cons.	30	30	30	30	30	30
Total Use	283	283	305	336	315	290
Ending Stocks	32	62	42	50	32	35
Total Distribution	315	345	347	386	347	325
CY Imp. from U.S.	0	1	0	1	0	1
CY. Exp. to U.S.	2	2	3	13	3	10
TS=TD		0		0	0	0

For 2013 Post has revised downward total cheese production in New Zealand by 7%, to 270,000 MT. This represents a 15 percent decline in total production compared with 2012, when New Zealand cheese production peaked at an estimated 319,000 MT While New Zealand has several stable cheese markets, cheese is significantly more costly to manufacture than the milk powders and is mostly produced at peak milk supply periods (Oct-Dec) when all the other processing facilities are at full capacity. During the record peak in 2012 more cheese manufacturing was necessary in order to process the very high daily milk intakes. In 2013 there will be more drying capacity on stream and the spring peak milk supply is unlikely to be as high as 2012. This is the main factor underlying Post expectations for cheese production in New Zealand to moderate from year-earlier levels.

Trade and Inventories

Exports

New Zealand PSD Summary Table for Dairy Product Exports									
PSD Commodity (1000s Metric Tons)	2011	2012 Revised Actuals		2012 % change from 2011	latest revision 2012 % change	2013 Revised Forecasts		2013 % change from 2012	latest revision 2013 % change
	Actual	Post Oct'12 forecast	Revised Actual 2012			Post Oct'12 forecast	Revised forecast 2013		
WMP	1,110	1,218	1,261	13.6 %	3.5%	1,275	1,285	1.9%	0.8%
SMP	362	375	390	7.7%	4.0%	390	405	3.8%	3.8%
Butter/AMF	449	480	506	12.7 %	5.4%	474	474	-6.3%	0.0%
Cheese	253	275	306	20.9 %	11.3%	275	260	-15.0 %	-5.5%
Liquid Milk	123	100	96	-22.0 %	-4.0%	120	110	-8.3 %	-8.3%
Sub-Total PSD Exports	2,297	2,448	2,559	11.4 %	4.5%	2,534	2,534	-1.0%	0.0%
Non PSD Exports	219		257	17.4 %			220	14.5 %	
Total Exports	2,516		2,816	11.9 %			2,754	-2.2%	

Source: GTA, Post estimates, note AMF component of Butter/AMF row is reported in butter equivalents (i.e. x1.22)

New Zealand Dairy Product Exports							
Annual Series: 2008 - 2012						% Chang e 2012 to 2012	% of Total Mark et Share 2012
Destinati on Country	United States Dollars						
	2008	2009	2010	2011	2012		
China	374,212,476	667,100,797	1,387,668,441	1,788,885,585	2,176,270,239	21.7%	21.4%
United States	705,889,142	541,790,684	514,622,520	673,265,041	748,943,130	11.2%	7.3%
Japan	486,583,886	315,095,640	404,797,950	469,192,189	464,714,932	-1.0%	4.6%
Saudi Arabia	370,671,896	191,141,262	286,994,438	389,862,485	386,347,133	-0.9%	3.8%
United Arab	89,628,872	150,276,690	196,673,987	323,639,336	374,171,333	15.6%	3.7%

Emirates							
Malaysia	370,767,506	222,863,846	286,114,714	366,393,506	368,937,256	0.7%	3.6%
Venezuela	466,664,815	224,827,725	334,980,025	378,373,326	367,311,578	-2.9%	3.6%
Philippines	386,339,329	260,750,453	389,398,486	414,122,031	363,501,927	-12.2%	3.6%
Indonesia	337,721,498	238,599,819	265,430,630	315,336,429	353,074,274	12.0%	3.5%
Australia	366,541,558	259,414,036	396,888,017	426,393,143	348,932,011	-18.2%	3.4%
Other Destinations	3,415,092,620	2,654,995,064	3,682,081,460	4,655,599,619	4,240,501,864	-8.9%	41.6%
World Total	7,370,113,600	5,726,856,013	8,145,650,665	10,201,062,694	10,192,705,672	-0.1%	100.0%

Source: GTA

Export volumes tend to vary with production levels because domestic consumption is stable and is very small relative to the production levels. There is not an exact fit on an annual basis because inventory levels at December 31 in any given year are highly influenced by any marked increases or decreases in milk supply in the peak supply months of October through to December. For example because of the record peak milk supply in 2012 generally inventories will have grown because there is a normal stock holding period as product comes out of the manufacturing process prior to being shipped. This does not alter to any great degree because of increased production. During the end of 2012 going into 2013 demand for product was brisk and while Post estimated that inventories increased, product has been shipped at a normal rate.

WMP production in 2013 is forecast to be just slightly ahead of 2012. This combined with the forecast that inventories are likely to be reduced by year end should result in WMP exports reaching the forecast 1.3 million MT.

New Zealand Export Statistics for Whole Milk Powder						
Destination	For Calendar Years in Metric Tons					
	2007	2008	2009	2010	2011	2012
China	51,237	44,800	171,491	294,408	302,261	423,435
Venezuela	74,043	98,922	78,213	97,021	90,078	92,807
United Arab Emirates	17,408	12,852	44,572	43,424	67,700	91,893
Algeria	37,533	49,101	59,801	45,178	79,602	75,426
Sri Lanka	53,554	48,320	45,020	57,091	64,398	56,927
Saudi Arabia	40,056	32,345	34,851	28,538	37,701	42,512
Malaysia	40,567	46,108	35,266	31,231	38,218	41,703
Indonesia	28,000	42,888	32,887	23,342	29,955	32,690
Vietnam	22,075	7,400	12,986	16,423	24,422	31,146
Bangladesh	4,262	2,918	12,574	15,104	29,115	31,144
Rest of World	310,958	220,954	290,419	296,941	346,182	341,591
Total to all Destinations	679,695	606,611	818,080	948,700	1,109,635	1,261,278
Av. Price/MT all Exports	\$3,021	\$4,244	\$2,299	\$3,300	\$3,780	\$3,404
Est.NZ Share of Total Global Trade in WMP	34.6%	27.4%	36.7%	40.9%	45.9%	49.8%

Source: GTA

Post has estimated that inventory levels for SMP were built up in spring 2012, again because of the record flows of milk. Post expects inventory levels to decline from an estimated 70,000 MT at the start of 2013 to 65,000 MT at year-end, which will boost exports slightly. If inventories drop back to pre 2012 levels at around 55-60,000 MT this would create extra exports in 2013.

With regard to Cheese, over the last two years the unprecedented surge in milk production has meant extra cheese was produced in order to process all the milk. Because of the ageing process needed as production grows so does inventory. From 2011 inventory levels have expanded by an estimated 55% peaking in 2012. During 2013 inventories are likely to be reduced back below 2011 levels. While production is likely to be sharply reduced in 2013 there will be a lagged effect on export volumes as the inventories are sold down.

New Zealand Export Statistics for Cheese									
Calendar Years : 2010 - 2012									
Destination Country	2010			2011			2012		
	Total Value USD	Quantity (MT)	Price/ MT	Total Value USD	Quantity (MT)	Price/ MT	Total Value USD	Quantity (MT)	Price/ MT
Japan	214,740,929	53,346	4,025	255,719,847	61,175	4,180	250,867,077	64,754	3,874
Australia	225,635,101	54,289	4,156	206,543,167	46,471	4,445	183,361,015	45,619	4,019
Korea South	78,442,930	19,210	4,083	90,011,297	20,085	4,482	100,748,582	25,457	3,958
China	48,863,160	11,702	4,176	57,483,243	13,536	4,247	76,477,597	17,852	4,284
Saudi Arabia	33,761,988	8,843	3,818	29,106,395	6,940	4,194	66,291,668	18,862	3,515
Indonesia	30,740,889	7,718	3,983	38,815,811	8,800	4,411	49,356,936	13,352	3,697
Philippines	42,461,486	10,867	3,907	42,709,387	10,186	4,193	45,790,231	12,545	3,650
United States	13,220,050	5,291	2,499	4,849,033	1,876	2,585	42,670,341	12,588	3,390
Egypt	19,013,226	5,507	3,453	22,353,193	5,990	3,732	35,958,616	10,361	3,471
Malaysia	22,307,144	5,084	4,388	19,772,022	4,712	4,196	24,686,608	6,031	4,093
All Other Destinations	308,702,706	82,965	3,721	312,613,981	73,091	4,277	301,911,975	78,225	3,860
World Total	1,037,889,607	264,819	3,919	1,079,977,376	252,858	4,271	1,178,120,646	305,647	3,855

Source: GTA

Other Exports – Liquid milk

While liquid milk exports, which mostly take the form of UHT consumer ready packs, dropped by 22% in 2012 to 96,000 MT, they are expected to pick up again in 2013. Fonterra is commissioning a new UHT plant now and Miraka is due to commission a UHT line in 2014.

Policy

Trade Policy

On April 26, 2013 the, Minister for Primary Industries Nathan Guy, and his Chinese counterpart signed an "Agricultural Cooperation Plan" which builds on the FTA NZ has with China. The agricultural cooperation plan sets out areas in which there can be mutual benefits, such as on animal welfare and science, increasing productivity and building skills and knowledge.

DIRA Developments

Implementation of Trading Among Farmers necessitated changes to the Dairy Industry Restructuring Act (DIRA), the federal legislation which governs the Fonterra Co-operatives formation and operations. Importantly the freedom of entry/exit to the Coop by farmers was preserved in DIRA. DIRA regulates that the minimum size for the public fund (Fonterra Shareholders Fund) is to be NZ\$500 million. The methodology (Milk Price Manual) Fonterra uses to calculate the raw milk price paid to farmers was also encapsulated in DIRA, along with an audit function provided by the Commerce Commission. In addition there are new rules to ensure that Fonterra's share price reflects fair value if Trading Among Farmers does not proceed or proceeds and is unsuccessful. The amended DIRA was passed in to law on July 24th, 2012.

Furthermore, on November 14, 2012 amendments to the Raw Milk Regulations, part of DIRA, which regulate how independent milk processors can access raw milk from Fonterra were brought into force. The key amendments are:

- Large independent processors who collect a significant quantity of milk directly from farmers will have a three-season limit for accessing regulated milk;
- The total quantity of milk available under the Raw Milk Regulations will be set at approximately five per cent of Fonterra's milk supply, as provided for in the legislation;
- A range of maximum quantities will apply to processors accessing milk under the Raw Milk Regulations in different months of the season to reflect the seasonal nature of milk production;
- Processors who do not take much, or any milk, directly from farmers will be able to pay a fixed price for milk accessed under the Raw Milk Regulations and will not be subject to the "wash-up" process at the end of the season.

The new Regulations will take effect on the first day of the next dairy season, from 1 June 2013. The full details can be found by searching on "Raw Milk Regulations" in the website: www.legislation.govt.nz.

Milk Price Manual First Review by the Commerce Commission

In December of 2012 the New Zealand Commerce Commission released a final report of its first statutory review of Fonterra's milk price manual. The manual determines how Fonterra calculates the farm gate milk price, which is the price paid by Fonterra to dairy farmers for their raw milk.

This was the first of two statutory reviews that the Commission is required to undertake each milk season under the 2012 amendments to the Dairy Industry Restructuring Act 2001 (DIRA).

The Commission concluded that, to the extent they were able to assess it; Fonterra's manual was not inconsistent with the purpose of the DIRA milk monitoring regime, which is to promote the setting of a farm gate milk price that provides an incentive to Fonterra to operate efficiently while

providing for contestability in the market for the purchase of milk from farmers. They reported a couple of elements that they considered were not fully consistent with the efficiency aspect of the purpose, but which only have a minor impact.

There were three matters of concern, potentially material, which the Commission was unable to form a view on in this report. These matters were: the regions where plants are assumed to be added; the calculation of milk collection costs; and the treatment of assets that are no longer required. In addition the Commission said parts of Fonterra's milk price manual state general principles or high level rules, and went on to say that while these are not in themselves inconsistent with the purpose, they could be implemented in a manner that is. The Commission will next report in September 2013 and that review should have the Commission's views on these areas of concern.

Some players in the sector still believe the milk price manual gives Fonterra too much wiggle room to manipulate the raw milk price and the Commerce Commission has not been given enough teeth to enforce the intentions of the DIRA. However the investing public who purchased units in the Fonterra Shareholders Fund seem to be satisfied the raw milk price and the dividends, upon which they rely for a return, will be accounted for equitably.

For more details go to: [Statutory Review of Milk Price Manual page](#)

Dicyandiamide (DCD) Contamination Found In Some Dairy Products Spring 2012

Dicyandiamide (DCD), a chemical sprayed on to pastures by some farmers (approx 4% of farms) to inhibit nitrate leaching, was been found in trace amounts in some New Zealand milk powder products manufactured for export in September 2012. On January 25th, 2013 the Government of NZ announced the two fertilizer companies who sold the product had voluntarily withdrawn it from the market.

Despite assurances the contaminant, at the levels found, is not a food safety risk, trade to some destinations was temporarily disrupted and there was a media frenzy in New Zealand and China, where it brought back reminders of the melamine scandal. In the long term the issue is unlikely to harm trade of New Zealand dairy products. Since the beginning of February through to the beginning of April, 2013 the Global Dairy Trade auction price index has gained 45% which suggests that the majority of players in the Oceania market have put the issue behind them.

In NZ there was some fallout as to why there was such a delay in the release of the information and why not all members of the Dairy Companies Association of NZ (DCANZ) were informed immediately after the first test results were known, especially as all processors were eventually affected with positive tests. It seems that once MPI had ascertained there was no question that food safety was compromised then there was a delay while MPI consulted as to how best to handle the issue.

Westland Dairy Coop called for an agreed communication protocol for the sector to be put in place for any future issues of this kind so that all players in the sector are informed as soon as possible. In response on May 1, 2013 The Dairy Companies Association of New Zealand (DCANZ) announced it had met with the Ministry of Primary Industries and agreed to develop appropriate engagement protocols across dairy companies and MPI where a food integrity issue comes to light.

Industry News

Oceania Hub for Dairy Product and Derivatives Trading

Fonterra developed the Global Dairy Trade (GDT) Auction platform now managed by CRA International, Inc and the first auction of WMP was held in July 2008.

The Global Dairy Trade trading events are conducted as ascending-price clock auctions run over several bidding rounds. In each auction a specified maximum quantity of each product is offered for sale at a pre-announced starting price. Bidders bid the quantity of each product that they wish to purchase at the announced price. If the price of a product increases between rounds, to ensure their desired quantity a bidder must bid their desired quantity at the new, higher price. The trading event runs over several rounds with the prices increasing round to round until the quantity of bids received for each product on offer matches the quantity on offer for the product. Each trading event typically lasts approximately 2 hours.

Each trading event specifies a given quantity of product in up to 6 contract periods i.e. contract period 1 delivers the product in the next month from the auction date, up to contract period 6 which delivers the product in six months. With two auctions each month purchasers have 12 opportunities to purchase product for any given month.

There are now five vendors: Fonterra, Dairy America, Murray Goulburn, Arla, and Amul selling nine product groups. Over the last twelve months over 930,000 MT of AMF, Butter, Butter milk Powder, Cheese, Lactose, MPC, Rennet Casein, SMP, and WMP have been traded over the platform.

The New Zealand Stock Exchange (NZX) established contracts for Dairy Product Futures trading during 2010. The NZX announced in April 2013, that with 40,000 lots traded to date and international players using the contracts, it would extend the trading hours by opening the market at 2am (NZ time) creating a 14 hour trading day thereby making access easier for northern hemisphere traders. Only one dairy product futures contract, a CME domestic milk contract is traded with greater liquidity than the NZX group of contracts which includes Whole Milk Powder, Skim Milk Powder, and Anhydrous Milk Fat futures contracts. The futures contract delivery prices are based on the GDT auction prices for the month in question.

The NZX derivative products and the GDT Auction have made New Zealand an important hub for trading dairy products which also allows useful price discovery. Purchasers of dairy products now have new tools for price management in the face of increased market volatility.

Fonterra: Trading Among Farmers (TAF) and the Fonterra Shareholders Fund (FSF)

Under TAF, Fonterra is no longer required to issue and redeem farmer shares on demand; instead an exchange has been created that allows farmers to trade shares among themselves. In addition, a separate fund (the Fonterra Shareholders Fund) has been established that for the first time would allow public investment in the performance of Fonterra shares. The public fund has been established to ensure that adequate liquidity exists in the Fonterra share exchange. However, the public fund does not have voting rights in the Fonterra Cooperative. Under the new arrangement, Fonterra is no longer required to retain the liquidity (up to \$600 million) to cover redemption risk.

One bank analysis puts the advantage of Fonterra not having to maintain the contingent liquidity to cover redemptions at Fonterra now being able to pay an additional 2.6 to 6.3c/share in profit distributions. This would add approximately 4-10% to the distributable profit.

TAF commenced on November 30, 2012. At the same time units in the Fonterra Shareholders Fund began trading publicly on the NZX and ASX. The units issued at NZ\$5.50/unit went straight up to \$6.60 and by May 15th, 2013 were trading at NZ\$7.97. This has pulled the Cooperative shares along for the ride and although they trade on a market open only to Fonterra shareholders and a Registered Liquidity Provider they have risen from \$4.52/share to \$7.97/share as well. Just over 1.9 million shares have changed hands so far from 458 trades, which is roughly equivalent to the shares needed for 15 to 17 average sized farms. The FSF has seen 112.5 million units traded since November equivalent to every unit issued having traded at least 1.5 times.

Fonterra Strategy Refresh

During 2012 the Board and management have reviewed the business and have identified seven key strategic paths to move along over the short to medium term. Implementation of the strategy is now becoming evident. The seven pathways are:

- 1. Optimize New Zealand Milk.** Fonterra is not only encouraging greater milk production but is actively concentrating on the sustainability of production.
- 2. Build And Grow Beyond Its Current Consumer Positions:** Fonterra is aiming to very pro-actively build its own brands positions and market shares in the consumer markets of Australia-New Zealand, Asia, Latin America, the Middle East and North Africa.
- 3. Deliver On Its Foodservice Potential:** The foodservice business already operates in 50 countries and generates more than NZ\$1 billion in sales per year. It has announced it has extended its food service business to a further 21 cities over the last 12 months and this development will continue. Research and development will have a big role in developing new products and solutions for commercial kitchens.
- 4. Grow Its Position In Mobility:** Fonterra plans to extend the Anlene bone health brand and develop new mobility solutions for our ingredients customers, especially in China.
- 5. Develop Leading Positions In Pediatrics' And Maternal Nutrition:** Fonterra has already announced it will extend its Anmum infant formula brand from Malaysia and Indonesia into China in the second half of 2013. Fonterra's R & D work will support this business with focused research on milks for brain development and immunity.
- 6. Selectively Invest In Milk Pools:** while continuing to grow sustainably the milk supply New Zealand Fonterra will continue to invest in growing its own milk supplies in Australia; Latin America; and China.
- 7. Align the Business And Organization to Enable the Strategy:** There has already been visible work here, 50-60 vacant staff positions at Head Office in Auckland are not being filled again. In addition it was announced in May 2013 that a few further 250 positions will be made redundant as the corporate head office functions are streamlined. The money saved will be reinvested to further implement the rest of the strategy refresh.

For more information on the changes Fonterra is implementing go to:

<http://www.fonterra.com/nz/en/About/Our+Strategy+Refresh>